No. 22507-A

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Everette H. Williams,

Appellant,

vs.

Rose City Development Company, Inc.,

Appellee.

On Appeal From the United States District Court for the District of Oregon.

REPLY BRIEF OF APPELLANT.

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REPLY BRIEF OF APPELLANT.

I.

ROSE CITY'S SECURITY INTEREST WAS UNPERFECTED UNDER THE CODE ITSELF.

A. The Court Should Consider the Trustee's Argument in This Connection Despite the Failure to Urge the Point Below.

In the trustee's opening brief, we point out that Rose City had no written security agreement and no financing statement relating to its transactions with the bankrupt, as distinguished from transactions with the predecessor corporation. These deficiencies provide a further basis for holding the transfers in question to be preferential. Moreover, independently of the preference theory, the defect is fatal to Rose City's security interest under the Code itself and §§70a and c of the Bankruptcy Act.

Rose City's primary response to this argument is that it comes too late and cannot be considered by this court. There is, of course, a general rule that new issues should not be raised for the first time on appeal. But it is equally well-settled that the rule is not based upon a lack of power in the reviewing court, and in a number of situations exceptions have been made. For example, this court has previously stated that:

> "There is . . . no rigid and undeviating judicially declared practice under which courts of review invariably and under all circumstances decline to consider all questions which have not previously been specifically urged. Indeed there could not be without doing violence to the statutes which give federal appellate courts the power to modify, reverse or remand decisions 'as may be just under the circumstance.' 28 U.S.C.A. §2106. Exceptional cases or particular circumstances may prompt a reviewing court, where injustice might otherwise result or where public policy requires, to consider questions neither pressed nor passed upon below." *Neulsen v. Sorensen,* 293 F. 2d 454, 462 (9th Cir. 1961).

The principle which underlies the general rule against raising new points on appeal involves considerations of fairness. That is, litigants should have ample warning in the trial court of all issues upon which the matter is to be decided so that they may offer all the evidence they believe relevant. Where, as in the present case, the new contention involves solely a question of law on undisputed facts,[1] there has been no deprivation of the parties' opportunity to present evidence, and an exception to the general rule is especially justified. *E.g.,*

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[1]It is conceded that Rose City obtained no new financing statement or security agreement and the details of the merger appear without dispute in the record.

Foster v. United States, 329 F.2d 717 (2nd Cir. 1964); *United States v. Merrill,* 211 F. 2d 297, 302-303 (9th Cir. 1954); *Cf., Leedom v. International Brotherhood of Elec. Wkrs.,* 278 F.2d 237, 244 (9th Cir. 1960).

Moreover, it would be less than fair under the circumstances of the present case to preclude the trustee on a technical ground from arguing a crucial legal issue. In support of Judge Solomon's decision, both Rose City and the Permanent Editorial Board For the Uniform Commercial Code, as amicus curiae (hereafter the "Board"), now rely primarily on the substitution of collateral doctrine. This theory was not asserted before the Referee. Indeed, there was no evidentiary basis for it until Exhibit 39 was stipulated to after the Referee's decision. Thus, Rose City should not be heard to complain about the trustee's raising a new point on appeal when it, or an amicus curiae in support of its position, actually raised a new point at the first appellate stage of this controversy.[2]

B. On the Merits, the Failure of Rose City to File a Financing Statement for Transactions With the Bankrupt and to Obtain a New Security Agreement After the Merger Was Fatal to the Security Interest in the Bankrupt's Accounts.

1. The Failure to File a Financing Statement.

In our opening brief, we contended that Rose City's security interest in the accounts of the bankrupt arising after the merger was unperfected under the Code itself, since no financing statement was signed by nor

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[2]As noted a Code proponent as Peter F. Coogan, Esq. of Boston, who contends that Rose City should prevail on the substitution of collateral theory, finds very little room to disagree with Referee Snedecor on the basis of the record before him. Advanced ALI-ABA Course of Study on Banking and Secured Transactions Under the Uniform Commercial Code, *Course of Study Transcript* 2 at 231 (1968).

filed with respect to the bankrupt as distinguished from the predecessor corporation (Op. Br. 17-20). Rose City and the Board respond that under §§9-403(2) and 9-306(2) of the Code a filed financing statement is effective for five years, and a security interest continues in collateral notwithstanding its transfer by the debtor. But this response is irrelevant to the present case. At most, application of the sections referred to means that Rose City's security interest in the accounts generated by the predecessor corporation would have continued perfected for five years even though they were transferred to the bankrupt in the merger. The question before this court, however, is not whether Rose City's rights continued in the transferred accounts. Rather, it is whether Rose City had a perfected security interest in the accounts generated after the merger by an entirely distinct legal entity.

The Board also points out that the official draft of the Code contains provisions (not adopted in Oregon) which permit the secured party alone to sign and file a financing statement where unilateral action of the debtor in changing his residence or moving or selling the collateral, will terminate the perfected status of the security interest. From this it is concluded that "if the debtor could similarly jeopardize the perfection by changing his or its name, the Code would have given the secured party the same protection" in the name change situations (Board Br. 10). Here, however, we do not have a situation involving a mere change of name by one debtor.[3] We have a change of debtors.

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[3]Even if only a name change were involved, the Board's argument is not persuasive. Provisions for filing by the secured party alone—*i.e.*, the single signature financing statement situations—are designed for the protection of a secured party whose existing security interest is threatened by the debtor's act. As to future security interests or security interests in future collateral, the secured party has the power before committing him-

For the purpose of the requirement of a new financing statement with respect to future transactions with a new debtor, the present case should be no different from any other where a buyer of a business assumes all the liabilities of the seller. No one would contend that in such event the secured party may rely on a financing statement of the seller to perfect a security interest in collateral acquired from other sources by the buyer after the sale.

It is true, as Rose City and the Board point out, that under §9-402(5) of the Code a financing statement is effective despite minor errors, provided they are not seriously misleading. But this section presupposes that there is on file some financing statement executed by the debtor. It does not purport to excuse a new filing where, as here, there is a change of debtor, even if the name and address of the new debtor were identical to those of the old. Moreover, this is certainly not a case where §9-402(5) would save Rose City in any event. The old financing statement relating to the predecessor corporation would indeed be seriously misleading insofar as transactions with the bankrupt were concerned.[4] A search of the public record for security interests in the assets of Portland Newspaper Publishing Co., Inc. would not give the notice of Rose City's claim as contemplated by Oregon's Uniform Commercial Code.

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self to insist upon the debtor's executing a new financing statement. The Board's point, therefore, if it is relevant at all, has validity only insofar as it relates to accounts in existence at the time of the merger. As to accounts thereafter generated, Rose City did not need a single signature provision; it could have demanded a new financing statement relating to those accounts before releasing any of the old collateral.

[4]The Board takes a very equivocable position on whether the "slight change of name" is seriously misleading. (Board Br. 11).

2. The Failure to Obtain a New Security Agreement.

Concededly the bankrupt never signed a security agreement relating to its accounts. Rose City and the Board nevertheless contend that the security agreement executed by the predecessor corporation taken together with the merger agreement signed by the bankrupt satisfy the requirements of §9-203(1)(b). We submit that this is too much of a relaxation of what the section demands. It is not difficult to comply with the simple formalities of the writing contemplated by the Code. To hold sufficient the generalized assumption of all liabilities and duties, as contained in the bankrupt's merger agreement, renders §9-203(1)(b) virtually meaningless. In the security agreement it signed, the predecessor corporation did not, indeed could not, undertake to grant a security interest in the assets of some other legal entity. And while the bankrupt may have agreed to take its predecessor's assets subject to the predecessor's debts and to pay those debts, the merger agreement in no way purported to secure those debts by property to be acquired by the bankrupt in the future.

In its brief the Board poses a hypothetical case where a construction business acquires a small architectural firm in a merger (Board Br. 8). We agree with the Board that "a security agreement covering the accounts receivable of the architectural firm would probably not pick up the accounts receivable arising, after the merger, out of the construction side of the business." (We submit, also, that the architectural firm's old security agreement would not pick up accounts generated by the construction firm, after the merger, arising out of its new architectural business).

We further agree with the Board that "under general merger principles, a security agreement covering construction machinery owned and to be acquired in the future by the construction company would be construed

to survive the merger and cover any such equipment acquired thereafter." But this is beside the point. We do not contend that the acquisition of new assets by a debtor—whether by merger, purchase, or by any other means—affects the validity of a previous security agreement made by that debtor.

The Board reaches the correct result in both instances because the surviving entity in its hypothetical case is the construction firm. But it erroneously suggests that the relative sizes of the merged and surviving corporations and the nature of their businesses bear on this result. Contrary to the Board, we submit that for present purposes it should not be important whether a smaller corporation merges into a larger one, or the larger merges into the smaller, or whether the two entities are in the same, related or different lines of business. To make distinctions regarding the requirement of a new security agreement based on these differences is both unworkable and not justified on policy grounds.[5] What should be and is crucial under the Code is that the debtor whose collateral is looked to has signed the requisite agreement.

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[5]Does the Board propose a rule to the effect that if the acquired company is large, security agreements signed by it which include after-acquired property clauses will also bind assets acquired by the surviving corporation in the future, but if the acquired company is small, the result is different? In such event, how is size to be measured—relatively, absolutely, by net worth, number of employees, value of assets, capital investment? Does it matter that in the Board's hypothetical case the acquiring business was engaged in construction whereas the acquired firm rendered architectural services? We note that the Board states only that a security agreement covering all "accounts receivable" would not cover future accounts arising "out of the construction side of the business." Would the Board propose that the old agreement could cover all of the future architectural accounts even if the surviving business substantially increased the size of its architectural department? How would the Board's rule apply to a receivable which results from a single billing by the construction firm for both architectural and construction services rendered in the planning and construction of a new building?

II.

THE SUBSTITUTION OF COLLATERAL DOCTRINE DOES NOT SAVE ROSE CITY'S SECURITY INTEREST FROM INVALIDATION AS A PREFERENCE.

In support of Judge Solomon's decision that the security interest was non-preferential, both Rose City and the Board now place primary reliance on the substitution of collateral theory. This was not the position taken before the Referee, and although the Board did argue it fully on review, Judge Solomon's ruling was based mainly on various other grounds.

Our opening brief analyzed the substitution doctrine and pointed out why it could not be applied on the present record (Op. Br. 44-47). One reason is that Exhibit 39 is the only evidentiary basis for application of the doctrine and it is insufficient for that purpose. The reply of Rose City and the Board in this connection is that the trustee carries the burden of proof as to all elements of a preference. But their argument is not responsive. As will be shown, the trustee need not, as part of his prima facie case, negate the doctrine's applicability.

There is no quarrel with the generalized statement that the trustee has the burden of proof—that is, the risk of persuasion—with respect to all elements of a voidable preference. We submit, however, that in Rose City's case the trustee at least carried his burden of producing evidence—that is, he made a prima facie case—when he established that the accounts in question arose after June 15, 1964, *i.e.,* during the four months' period, that the debt for which they were security was incurred in 1963, that the accounts in existence on June 15, 1964 were no longer in existence at bankruptcy, and that there was both insolvency and the element of reasonable cause to believe. At the end

of the trial, the Referee determined in effect that the trustee had carried the burden of proof as well as the burden of producing evidence; accordingly, he held against Rose City.

At this point in the case, the evidence now relied upon to support the substitution doctrine—Exhibit 39—had not been introduced, and there was no occasion to make findings of fact on that issue. Acceptance of the suggestion that the trustee did not carry his burden of proof logically leads to the result that the substitution theory should have saved Rose City even without Exhibit 39. Yet it is plain that on the record before him Referee Snedecor was correct in not requiring the trustee to negate the possibility of substitution of collateral. *Cf. Wolfe v. Bank of Anderson*, 283 F. 343 (4th Cir. 1916); see *San Mateo Feed & Fuel Co. v. Hayward*, 149 F.2d 875 (9th Cir. 1945).

It was only after the Referee's decision that Exhibit 39 was introduced. We can concede for the moment that once the creditor has gone forward with evidence of substitution of collateral, the trustee has the burden of persuasion with respect to whether or not the requisite conditions exist for application of the doctrine. But it was unnecessary for Judge Solomon to make any new findings of fact relevant to the substitution argument since he approached the case from a different standpoint;[6] accordingly, he did not consider whether the trus-

[6]The closest Judge Solomon came to making a finding relevant to the substitution issue was his observation that during the four months' period accounts totaling $397,860.24 were collected by the bankrupt and replacements were made totaling $395,085.87. We pointed out in our opening brief that the $397,860.24 figure derived from Exhibit 39 does not establish that this sum was actually collected; that is, the record does not indicate the extent to which the figure includes credit memos and write-offs (Op. Br. 45). More fundamentally, as we also demonstrated, the substitution doctrine cannot be

(This footnote is continued on the next page)

tee had, or met, the burden of proof in this connection. As a result, the most Rose City can ask for here is a remand for further findings of fact unless Exhibit 39 establishes to the satisfaction of this court, as a matter of law, that it would be impossible for the trustee to carry the burden of proof. Of course, the exhibit is far short of conclusive as was demonstrated in our opening brief (Op. Br. 45-47).

Finally, we submit that in most cases where substitution is urged the trustee, upon analysis, is not the one with the burden of proof on that issue. That is to say, the doctrine usually relates to a potential defense rather than to one of the affirmative elements of a preference. The doctrine requires that the replacement of new collateral must be either (1) simultaneous with or (2) precede the release of the old security (Op. Br. 44). In the first, less common situation, *i.e.,* the simultaneous exchange, present consideration is given and the antecedent element of a preference is lacking.

The analysis is somewhat different in the more common situation of the replacement preceding the release. It can be illustrated by this example: At the beginning of the four months period, a creditor holds valid collateral worth $10,000 to secure a $10,000 debt. Within the period the debtor transfers another $5,000 of collateral as additional security, and the secured party subsequently releases to the debtor $5,000 of the original collateral. Even assuming the existence of the various other elements of a preference and reasonable cause to believe, the substitution of collateral doctrine bars the trustee from avoiding the $5,000 transaction.

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applied by comparing aggregates of releases and replacements during the four months (Op. Br. 41-42); *Cf. Cooper Petroleum Company v. Hart,* 379 F.2d 777, 780-782 (5th Cir. 1967). Thus, the totals referred to by Judge Solomon are not relevant to the issue here under discussion.

This is true despite the fact that all the elements of a voidable preference exist. The result in this situation turns on §60c of the Bankruptcy Act, which in effect permits a creditor to offset against an otherwise recoverable preference any unsecured credit extended to the debtor after the preference.[7] Section 60c plainly relates to defensive matter rather than to the trustee's cause of action. When the substitution doctrine is invoked in this context, therefore, the burden of proof with respect to it is borne by the creditor.

III.

SECTION 9-108 OF THE CODE IS INAPPLICABLE BY ITS OWN TERMS.

In our opening brief, we argued that Rose City's security interest in the bankrupt's accounts failed to meet the "new value" requirement of §9-108 (Op. Br. 24-25). The Board, however, asserts that the release of collateral after the making of the security agreement and up to the beginning of the four months' period suffices to make §9-108 applicable (Board Br. 36). It is submitted that this is not a fair reading of the section. The value which is referred to as "new" must be given by the secured party at the inception of the transaction whereby the debtor grants a security interest in his after-acquired property—neither before nor afterwards. If this is not plain from the language of §9-108 itself, the official comment makes it so:

> "Two tests must be met under this section for an interest in after-acquired property to be one

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[7]Section 60c, 11 U.S.C. §96c:

> "If a creditor has been preferred, and afterward in good faith gives the debtor further credit without security of any kind for property which becomes a part of the debtor's estate, the amount of such new credit remaining unpaid at the time of the adjudication in bankruptcy may be set off against the amount which would otherwise be recoverable from him."

> not taken for an antecedent debt. First: the secured party must, *at the inception of the transaction,* have given new value in some form." UCC §9-108, official comment 1 (emphasis added).

In other words, §9-108 is not intended to be applicable unless the original granting of the security interest would have been non-preferential in a bankruptcy filed at that time. *Cf.* Hogan, *Games Lawyers Play With the Bankruptcy Preference Challenge to Accounts and Inventory Financing,* 53 Cornell L. Rev. 553, 569 (1968), *reprinted* at 1 Coogan, Hogan, Vagts, Secured Transactions Under the UCC §11.13[1] at 1212 (1968 ed.).

IV.
THE REFEREE'S DECISION DOES NOT IMPAIR OR INCREASE THE COST OF LEGITIMATE FINANCING OF RECEIVABLES.

The argument of the amicus curiae brief of National Commercial Finance Conference, Inc. is that if Rose City's security interest cannot withstand the preference challenge, flexibility in receivables financing will be impaired and financing charges to the small business borrower will be higher. The contention is unconvincing for at least two reasons. First, the financing of the bankrupt and its predecessor was far from a normal commercial transaction. There is no comparison between the manner in which Rose City handled its loans and what one would expect from a professional lender.[8]

Secondly, despite §9-108 and the abolition of the *Benedict v. Ratner* rule, we have been shown no evi-

[8]Peter F. Coogan, Esq., has characterized the *Portland Newspaper* case as follows: ". . . this was a case where amateurs made all the mistakes that amateurs can make." Advanced ALI-ABA Course of Study on Banking and Secured Transactions Under The Uniform Commercial Code, *Course of Study Transcript* 2 at 230 (1968).

dence that the liberalizing provisions of Article 9 have in fact enabled the commercial finance and factoring industry to reduce its operating costs significantly. Even more is it to be doubted that the cost savings, if any, have been passed along to the small borrower. As was referred to in our opening brief, the practical problems are such that *Benedict v. Ratner* aside, some "policing" of the collateral remains necessary, and this is so regardless of the preference section (Op. Br. 49-50). Professor Gilmore explains:

> "Under §9-205, Article 9 repeals the rule of *Benedict v. Ratner* and any other lingering vestiges of *Twyne's Case*. A secured party is no longer required, as a matter of law, to 'police' his debtor's affairs on pain of having his security transaction treated, if he fails to meet the policing requirements, as a fraudulent conveyance. Nevertheless, the Code draftsmen recognized as sound the idea that a secured lender, particularly if he takes as security the inventory and receivables which are the most liquid assets of any enterprise, should, not only in his own interest but in the interest of other creditors, be under compulsion to pay close attention to the course of the debtor's affairs. We have suggested in another context why self-interest alone should be enough to insure that any lender who understands what he's dealing with will in fact observe the substance of the desirable patterns of financing which, in the area of receivables, developed in the wake of the *Benedict* case. If self-interest does not do the job, §9-306(4)(d) supplies the incentive. If a secured party, relying on the abolition of the *Benedict* rule, allows his debtor to make unrestricted use of proceeds and collections, paragraph (4)(d) puts beyond his reach, if insolvency proceedings occur,

everything except the last 10 days' receipts. To protect himself the secured party will have to require periodic accounting; if he does not pick up the proceeds at 10-day intervals, he will lose them irretrievably in the one contingency where he will ever need them—the institution of insolvency proceedings. In a word, to have the benefit of his security in the form of proceeds or collections, he will have to be the debtor's policeman, exactly as he had to be in the palmy days of *Benedict* theory."

II GILMORE, SECURITY INTEREST IN PERSONAL PROPERTY, p. 1340 (1965).

V.

IF ROSE CITY'S SECURITY INTEREST IS UPHELD, THE CASE MUST BE REMANDED FOR FURTHER PROCEEDINGS.

We contended in our opening brief that a remand for further proceedings would be necessary if Rose City's security interest is upheld and the DuBay and Davis interests invalidated (Op. Br. 50-51). In such event two questions would remain unanswered, namely: May the trustee preserve the senior DuBay and Davis claims for the benefit of the estate? Did the parties intend to assign to Rose City the accounts meant for DuBay and Davis?

Rose City apparently misunderstood our position, for it asserts in response that "The trustee can only claim subrogation rights as the privy of Davis," and he cannot raise this point for the first time on appeal (Rose City Br. 9).

The trustee's attempt to preserve the DuBay and Davis security interests is not a new one. His pleadings before the Referee sought that relief but the point became moot when Rose City's security interest was

held invalid. It will be of importance again, however, if Judge Solomon's decision is affirmed in all respects.

The issue of whether Davis could compel Rose City to subordinate its claim to his, decided in the negative by Judge Solomon, is not the same as whether the trustee can preserve the Davis (or DuBay) security interest for the benefit of the estate. Rose City simply is incorrect in the statement that the trustee's claim is "as the privy of Davis." The trustee's ability to preserve is part of his avoiding powers under the Bankruptcy Act, see §60b, 11 U.S.C. §96b; §70e(2), 11 U.S.C. §110e(2), powers which Davis and DuBay themselves never possessed.

Finally, there remains an unresolved factual issue as to whether there was any intention to assign to Rose City the accounts designated for DuBay and Davis (Op. Br. 46, n. 15 and accompanying text). This is independent of the preservation or subrogation question. If, as the evidence seems to indicate, no such intent ever existed, Rose City could not claim the DuBay and Davis accounts under any circumstances.

Conclusion.

For the reasons set forth in Appellant's Opening Brief and in this Reply Brief, the order below should be reversed to the extent it upheld the validity of the alleged security interest of Rose City Development Company, Inc.

Respectfully submitted,

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